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Considering foreign direct investment in Denmark

The eclectic paradigm of Dunning revisited

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Abstract

The present paper examines the aspect of relational assets and relates it to the strategic decision on undertaking foreign direct investment (FDI). The point of departure is the increasing importance of FDI globally as well as in the Danish economy, and the observation that even though Denmark actively participates in the international flow of FDI, both inwardly and outwardly, the Danish economy has only to a small extent been the target of Japanese efforts. Based on the gradual evolution of Dunning's eclectic paradigm in the field of internationalisation theory, the paper argues that the creation of relational assets is an important part, and increasingly so, of strategic FDI decisions, and that the ensuing importance of social capital makes it economically efficient to focus on economies with favourable conditions for cooperation and networking. Since social capital favouring the creation of relational assets characterises the Danish economy, and since Japanese FDI operations tend to favour the establishment of long-term commitments and relationships, there is a potential for increasing the mutual FDI flows between Japan and Denmark.

Background

Foreign direct investment (FDI) has increasingly become an important engine of the process of globalisation by which national economies become integrated and a refined division of labour between national economic systems develop. The integration of international capital markets has spurred the role of FDI, and especially during the 1990ies FDI has grown at rates higher than international trade and the growth of national economies (Patterson et al., 2004). More than 90 % of the inflows and about 70 % of the inflows of FDI are accounted for by industrialised countries especially in the form of equity capital, implying that the industrialised countries are the prime loci for the process of globalisation. Among the industrialised countries, the largest recipients of FDI are USA, UK, France and Germany.

According to Patterson et al. (2004), the growth of FDI has decreased during the new millennium. The same tendency can be observed in Denmark, but as in the general global case the size of inward and outward flows of FDI in any given year is still larger than the year before (Danmarks Nationalbank, 2004). It seems natural to hypothesise that even though the growth of FDI is settling down at lower rates, the effect on the national capital formation from FDI will continue to be increasingly important. The effect will primarily come from equity capital that according to recent figures for 2001-2003 comprises 70-80 % of the FDI capital inflow in Denmark (Danmarks Nationalbank, 2004).

The increasing importance of FDI makes it relevant to analyse what are the main drivers for FDI and what are the main benefits for the receiving national economy. These issues have from time to time during the last thirty years been important in the Danish national political debate where the public opinion has focused primarily on the loss of management control associated with acquisitions, mergers and joint ventures. While the benefits from acquisitions, mergers and joint ventures have played a minor role in the Danish debate, the international theoretical debate has devoted more attention to the potential benefits. Furthermore, while the issue of green field investments is important to the theoretical debate, it has played a minor role in the Danish debate in which green field investments have primarily been seen as a much welcome substitute for the outsourcing of Danish jobs to low-wage countries. In fact, the outsourcing of Danish jobs has played a dominant role in the Danish debate on globalisation even though recent analyses show that the trend of job destruction comprises no more than 3,500-5,000 jobs in an economy where 260,000 jobs are destroyed and created annually (Det Økonomiske Råd, 2004, Socialforskningsinstituttet, 2004).

However, even though the high rate of job destruction and creation in the Danish economy is the result of a highly dynamic labour market, e.g. as evidenced by the Danish textile and clothing industry (Olsen et al., 2004) as pointed out by Det Økonomiske Råd (2004), recent analyses suggest that the number of Danish jobs that potentially can be outsourced may be quite large, ranging from 375,000 jobs in sectors marked by industrial transition according to Rambøll Management (Ugebrevet A4, 2004) to 2 million jobs in the economy as a whole

(Brendstrup et al., 2004). The main argument advanced by Ugebrevet A4 (2004) is that low-wage countries are increasingly able to substitute the jobs of Danish low skilled workers, especially in traditional manufacturing industries, and that outsourcing opportunities in the service sector may imply that even an increased growth in services is not able to create new jobs at the same rate as traditional manufacturing jobs are destroyed. In consequence, the threat to manufacturing jobs is combined with an increasing threat to service jobs as well. Brendstrup et al. (2004) who has made an in-depth survey of 100 Danish firms collaborate that services are increasingly being outsourced to foreign destinations, especially in banking, ICT and engineering but also increasingly in more traditional service industries like transport and trade. However, they do at the same time advance the point of view that a reinforced participation in the international division of labour will contribute to future growth and job creation in the Danish economy, depending on the extent of competence development in management and the labour force. This argument is in line with results from previous Danish studies that have shown that technical and organisational innovation in Danish firms have generally been able to counteract job losses from the increased transformation pressure by globalisation (Lundvall, 2002).

In effect, the attraction of FDI will become an important issue in the future development of the Danish economy. While the next section shows the current amount of FDI in Denmark, the following section discusses the advantages of establishing economic activities abroad and touches upon the case of Japanese FDI. Subsequently, the pattern of Japanese FDI in Western Europe is reviewed and discussed with reference to the Danish economy. Finally, the discussion is summarised and some recommendations for future policy are advocated.

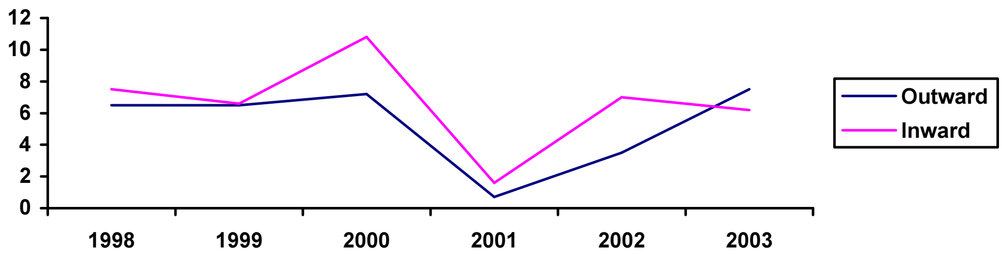
Foreign direct investment in Denmark

The Danish economy is closely integrated in the international division of labour in the sense that import and export are large as measured in terms of GDP, currently more than 45 % (Gjerding, 2005). However, the Danish economy is mostly integrated with neighbouring economies, notably Germany, Sweden and the UK. The role of proximity in international integration is marked in the case of FDI as well, cf. figure 1. In general, Denmark experiences an outward capital flow that is larger than the inward flow, however with the important exceptions of USA and Sweden that account for almost half of FDI in Denmark, both among the top-five Danish trading partners. As mentioned previously 70-80 % of the inward and outward FDI in 2001-2003 are in the form of equity capital. The profitability on outward equity capital during recent years (1998-2003) has been around 6 % while the profitability on inward equity capital has been slightly larger. The difference may reflect that financial intermediation and business services account for half of the inward flow while the outward flow is more evenly distributed among industries.

Figure 1. *Foreign direct investment, Denmark*

Billion DKR, 2003	*Outward flow*	*Inward flow*	*Balance*
Total	374,2	355,8	18,4
Old EU countries	105,6	73,6	32,0
New EU countries	27,1	1,4	25,7
UK	43,4	35,9	7,5
Sweden	32,4	71,6	- 39,2
Netherlands	24,6	22,8	1,8
Germany	22,0	15,9	6,1
USA	21,1	99,5	- 78,4
Japan	2,9	3,2	- 0,3

Surplus in per cent of equity capital, 1998-2003



Industries, % of FDI, 2003	*Outward*	*Inward*
Financial intermediation and business service	34	51
Manufacturing	26	13
Transport, post and telecommunication	12	10
Trade, hotels and restaurants	10	13
Other sectors	18	13

Source. Danmarks Nationalbank (2004)

Note: The figures account for net equity capital and loan capital, while pass-through investments are omitted

Undertaking FDI – the importance of relational assets

FDI is a way of acquiring ownership of assets in a foreign country and are in theories on internationalisation described as one of several participation strategies by which companies can internationalise. According to a previously well-accepted approach, i.e. the classic Uppsala school on internationalisation (Johanson & Vahlne, 1977), FDI would be an option only for companies with considerable international experience. In internationalising, companies would approach neighbouring markets or markets rather similar to the home market of the company by way of indirect or direct export, gradually developing relationships with sales agents or production companies at the foreign market before embarking on establishments and acquisition of assets at the foreign market. By using a piecemeal strategy, the company in question would gain experience and gradually become more motivated for stronger commitments as the experience of management moves along an internationalisation learning curve. However, as explained by Strandskov (1995) and Albaum et al. (1994), the Uppsala theory on learning stages became increasingly refuted during the 1980ies as researchers turned against the concept of a deterministic pattern of internationalisation (e.g. Turnbull, 1987) and looked into the problems of how to define the degree of internationalisation within a company's portfolio of activities. Furthermore, empirical studies increasingly showed diverse patterns of internationalisation that were not consistent with the Uppsala model. For instance, in his discussion on the Uppsala model Strandskov (1995, p.81) makes reference to a study of eighteen Swedish companies entering the Japanese market showing that more direct and rapid ways of approaching a market, including greenfield investments, were often used (Hedlund & Kverneland, 1985). In effect, the internationalisation strategies of firms became increasingly analysed in terms of managerial motives and the formation of international networks, and in terms of typologies of alternative strategic behaviours and roles at different international markets (Albaum et al, 1994, Kuada & Sørensen, 1997, Sørensen, 1997).

One of the most influential alternative models on international investment behaviour is the eclectic paradigm proposed and increasingly refined by Dunning (1977, 1979, 1985, 1988), also known as the Ownership-Location-Internalisation (OLI) paradigm. According to Dunning, companies engage in FDI in order to gain ownership specific advantages, locational advantages and internalisation advantages. Ownership specific advantages refer to the access to economic assets or rights that would not be easily obtained without direct investment at the foreign market, while locational advantages refer to endowments and attractions that are specific to the market where the company invest. Internalisation advantages occur when a company establish control of ownership specific and locational advantages. In combination, these advantages call for a strategy of direct foreign investments where ownership advantages and locational advantages constitute the opportunities for economic integration in the geographical space while internationalisation advantages constitute the prime strategic impulse for foreign direct investment (Morsink, 1998).

Empirically, Dunning (1986, 1998) developed the model through extensive studies of Japanese and American participation in British industry. One the main points is that while American investors often favour arm's length relationships and look for short term financial results, the Japanese investors look for establishing long term cooperative relationships where they aim to develop managerial principles at the foreign market based on relational assets. Relational assets are defined as "the stock of a firm's willingness and capability to access, create, to shape economically, and to coordinate the resources and capabilities necessary to beneficial relationships, and to sustain and upgrade the quality of these relationships" (Dunning & Narula, 2004, p.205). As the process of internationalisation in industrialised countries are increasingly based on knowledge-intensive relationships, the companies who possess and develop relational assets will gain a competitive advantage as compared to companies that are less focused on developing long term relationships at the market where they invest.

The debate on FDI in Denmark and abroad has often focused on the issue of ownership control, primarily caused by fear of what may happen if foreign companies take control of major parts of domestic economic activities. However, there is not a clear connection between FDI and ownership control. Empirically, FDI is associated with economic activities where the foreign investor controls at least 10 % of the activities in question (Patterson et al., 2004, Danmarks Nationalbank, 2004). However, controlling 10 % or even more does not assure *managerial* control. Traditionally, managerial control of existing activities is achieved by a major acquisition, but the importance of relational assets points to the fact that creating and sustaining relationships may be more important than ownership control of capital assets in the knowledge-based economy (Dunning & Narula, 2004). Thus, realising the importance of relational assets brings a new dimension to the strategic decision on FDI, implying that the most important strategic variable to be considered may be one of how to strike a balance between control of capital assets and control of relational assets. In consequence, the degree of commitment by FDI will depend on how much managerial influence can be created by relational assets.

The creation of relational assets is, essentially, a matter of creating conditions for cooperation. Whether cooperation takes place in a dyadic form or as a network with more than two partners, the essential of cooperation is the presence of trust, especially when knowledge-intensive activities are considered (Håkansson, 1989). Trust appears to develop through a process of learning where the cooperating partners get to know each other as they gain experience. In order for this process to take place, barriers in the form of opportunistic behaviour must be absent. If opportunistic behaviour is expected to occur, the creation of relational assets will depend on contractual arrangements or internalisation of activities. This is what is implied by the transaction cost approach (Williamson, 1975, 1986) where the establishment of hierarchical relationships are advocated in circumstances of non-trustworthy behaviour. However, since the establishment of hierarchical relationships is costly, the absence of opportunistic behaviour is economically more efficient. Thus, creating relational assets within a cooperative set-up hostile to opportunistic behaviour seems to be more efficient.

Increasingly, cooperative set-ups hostile to opportunistic behaviour and being more efficient than hierarchical relationships are, theoretically and empirically, described with reference to the concept of social capital. As described by Dunning & Narula (2004, pp.216), the concept of social capital may take different forms, ranging from cases where social capital is defined as "that part of a country's stock of tangible and intangible assets which is socially controlled or owned" (ibid.) to "the sum of the actual and potential resources embedded within, available through and derived from the networks of relationships possessed by an individual or social unit" (cited from Nahapiet & Ghoshal, 1998, p.243). More simply, social capital may be defined as "the ability to work with and trust others" (Lundvall, 2002, p.99), implying that social competencies are the foundation on which to build relational assets. Thus, to the extent that companies favour an FDI strategy that build upon the creation of relational assets, the determination of the nature of the social capital of the recipient country becomes important to the strategy decision making process.

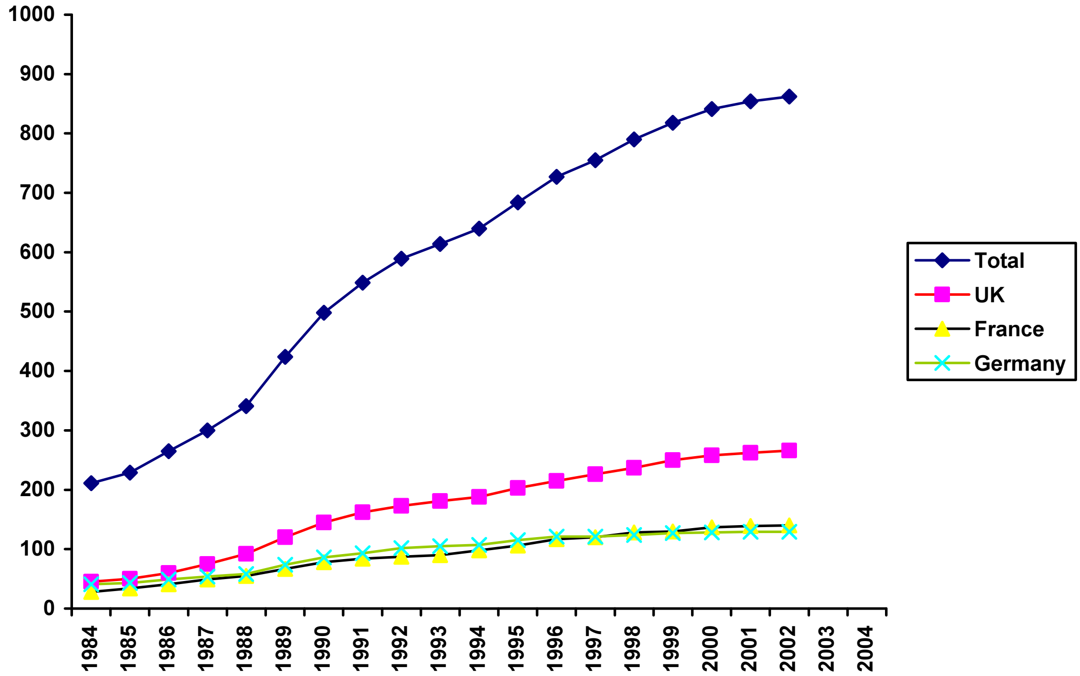
The pattern of Japanese FDI in Western Europe

Although Japan aims at playing a strategic role in Asia, the prime targets for Japanese FDI have traditionally been USA and Western Europe (Thomson & Nicolaides, 1991, Morsink, 1998). However, while USA a decade ago was the prime receiver of Japanese FDI, the relative positions of USA and Western Europe have changed during recent years. In 2002 and 2003, USA accounted for, respectively, 22 % and 29 % of Japanese FDI, while Western Europe defined as EU-15 accounted for, respectively, 41 % and 33 % (JETRO, 2004). UK and the Netherlands have traditionally been the prime Western Europe recipient countries for Japanese FDI, but during the last decade France has caught up, a development that started more than a decade ago (Morsink, 1998), and in 2002-2003 the FDI inflow from Japan in France was almost as big as the inflow in UK. The most important European country is the Netherlands where the FDI inflow in 2002-2003 amounted to half the size of the inflow in USA. Thus, Japan has increasingly been focusing on Western Europe for FDI activities with a special focus on three countries that are highly integrated in the global economy.

Among the prime drivers for Japanese FDI in Western Europe is the high per capita income in the region, the size of the EU market, and apparently a close relationship between trade intensity and investments (Morsink, 1998). Furthermore, Morsink (1998) points to the ease of overcoming cultural differences as an important explanation why Japanese FDI tend to concentrate in UK and the Netherlands. However, while Japanese FDI is important in the Netherlands, the Netherlands does not play an equally important part in terms of operating activities. Japanese manufacturing operations tend to concentrate in UK, France and Germany, cf. figure 2. In total, the JETRO 2002 survey points to 862 manufacturing affiliates in Western Europe of which 312 have R&D and design centres. In addition, 78 Japanese affiliates operate as R&D or design centres without manufacturing operations (JETRO, 2003).

The growing number of Japanese affiliates in Western Europe may reflect that Japanese companies have an inclination for greenfield operations as compared to acquisitions and mergers (United Nations, 2000). Theoretically, an inclination for greenfield operations have been associated with situations where the market is protected by barriers (like the EU) and where the building of trust is costly (Buckley & Casson, 2000). In the latter case, the propensity to undertake greenfield activities increases when the creation of relational assets are important, especially if the company favours long-term commitments, as has proven to be the case of Japanese FDI in previous studies (e.g. Dunning, 1986, Strange, 1993).

Figure 2. *Japanese manufacturing affiliates in Western Europe, 1984-2002*



Source: JETRO (2003)

In Denmark, where the proportion of Japanese FDI in total inward FDI is less than 1 % (cf. figure 1), the 2002 JETRO survey revealed 6 manufacturing affiliates, considerable less than the 18 affiliates found in Sweden (JETRO, 2003). Actually, only in the new millennium has the number of Japanese manufacturing affiliates in Denmark exceeded more than 4. This may be surprising since Denmark for more than three decades has been part of the European Community that is an important target for Japanese FDI. However, apart from a few countries Japanese investments in Western Europe has not been targeted at individual countries, but rather at the Western European region as a whole (Morsink, 1998) where the Danish economy plays a minor role. On the other hand, the Danish economy has been among the international front-runners in high inward FDI potential for more than a decade (United Nations, 2004) and provides good opportunities for FDI, especially FDI where the creation of relational assets is important. Apart from a stable macroeconomic climate and a long-term integration in the global economy (Gjerding, 2005), the Danish innovation system is well suited for developing knowledge-intensive activities that depends on social capital, cf. box 1. Furthermore, as indicated by figure 1, FDI in services play a major role in Danish inward FDI, reflecting that the

Danish economy takes part of the global trend of FDI focusing increasingly on services (United Nations, 2004). In consequence, Denmark may become a natural target for Japanese FDI in the future.

Box 1. *Social capital in Denmark*

In general the Danish innovation system is one dominated by small organizations and easygoing people. It is a flexible system in which it is relatively easy to do business, and it is not very formal. The key word is collaboration, both horizontally and vertically, internally within a business and externally in relation to customers and suppliers. The primary purpose of collaboration is incremental innovation in traditional product areas, and to an increasing degree in knowledge-intensive services as well. The fact that Denmark has managed to attain a high per capita income through utilizing such strategy demonstrates that it has depended on some "small-country advantages". Closeness in social relationships allows for rapid communication and allows problems to be solved when they arise without much waste in terms of formalities and social struggles.

Social capital will be especially important in a society where, as in Denmark, interactive learning and gradual innovation provide the basis for economic prosperity. In a society without mutual trust between individuals and groups, very little learning would take place, and one might wind up in a situation resembling that in Russia: because of the disintegration of social capital, a significant amount of knowledge capital is disappearing as well.

(Lundvall, 2002, p.100).

Conclusion

In his discussion of how the completion of the European internal market may impact on FDI, Dunning (2000) argues that European multinational enterprises have improved their competitiveness vis-à-vis US and Japanese multinationals. Explaining variables are, not surprisingly, market size, complementarity between FDI and trade, the changing structure of economic activity towards more knowledge-intensive areas, and agglomeration economies. This observation stresses the importance of small European economies taking part in the process of agglomeration and underlines the importance of non-EU investors undertaking FDI in Western Europe. In the case of Denmark, the present paper has argued that close integration in the global economy may pose threats in terms of job destruction, but at the same time opens up opportunities for job creating FDI, both related to inward and outward FDI flows. In addition, the paper has pointed to two observations. First, relational assets are becoming increasingly important as part of the internationalisation strategies of firms and may serve as mutually reinforcing conditions and outcomes of internationalisation processes. Second, the Danish economy has only to a minor degree been the target of Japanese FDI even though Japan is an important source of FDI to a group of global economies with whom the Danish economy is closely integrated, and even though the creation of relational assets is supposed to be facilitated by the nature of Danish social capital.

Based on these observations, it seems natural to advocate the need of a Danish national strategy on attracting Japanese FDI by combining purposes. The attraction of Japanese FDI to Denmark may be used as a vehicle for developing knowledge-intensive activities that can assist the Danish economy in taking part of the process of agglomeration occurring in the EU. At the same time, attracting Japanese FDI will assist the Japanese internationals in counteracting the competitive advantage of European internationals, especially at the Western European market. A national strategy should focus on developing the upcoming targets for FDI, i.e. services and research collaborations. Furthermore, attracting Japanese FDI may be combined by an improved effort in creating outward Danish FDI to Japan since the attraction of FDI is an increasingly important issue in the revitalisation of the Japanese economy (JETRO, 2004). At present, efforts to attract FDI is being pursued in Denmark, notably by Invest in Denmark which is an agency of the Ministry of Foreign Affairs, but also by a number of regional initiatives, and similar activities are going on in Japan. However, even though cooperative relationships exist, there still seems to be room for a more strategically focused national and regional effort combining Danish and Japanese forces. In reviewing the effectiveness of investment promoting agencies, Morisset & Andrews-Johnson (2004) suggest that four features are important when strategically addressing how to attract investments: Image building, investor facilitation and investor services, targeting specific sectors and companies, and create policy advocacy in the countries in question.

Regarding targeting efforts, a specific focus should be on customer-supplier relationships. In most developed countries, the political debate on globalisation has centred on the issue of job destruction as low-wage countries move into new commercial activities substituting domestic suppliers. However, a recent survey (Hansen et al., 2004) has shown that advanced customers increasingly demand suppliers to provide full-blown solutions to production problems, and in effect Danish suppliers may revitalise their competitive edge since they normally are able to combine process technological competencies with relational assets that strengthen the effectiveness of the value chain in which the cooperating firms take part. Technological spillovers to suppliers often occur in relation to FDI, even in cases where foreign investors do not actively seek to transmit technological knowledge (Potter et al., 2003), but the Hansen et al. (2004) survey may indicate that technological spillovers are equally likely to occur as transmissions from suppliers to FDI companies. In consequence, targeting customer-supplier relationships as part of a mutual FDI program focusing on creating relational assets implies great potentials for economic growth and employment.

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